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Acting on Time

T.K. JAYARAMAN

How does a central bank of a country have to act, decisively during a financial crisis or stand on high ground of independence?

Following the financial crisis in 2008, when the mortgage backed securities fell in value, America's central bank, the US Federal Reserve (the Fed) intervened. It did not stand on formality. The ultra-conservatives led by Congressman Ron Paul condemned the Fed action for "debasement of the dollar" through buying of private debt.

The US Fed did what was expected of it to save the financial sector from collapse.

As there was no private sector interest to buy new residential mortgage loans, the US Fed bought and guaranteed billions of dollars of new mortgages in the private sector. Buying private sector debt is not expected of a central bank, let alone government debt, as the latter amounts to financing deficits.

Lukewarm ECB

The European Central Bank (ECB) is common for the 17-member nation Eurozone. It is modeled after the Bundesbank, Germany's central bank, known for its anti-inflationary record and fierce independence. Its influence on ECB is strong.

So no wonder, ECB's response was lukewarm, since the debt crisis broke in October 2009.

The crisis was due to appreciation of euro and low interest rates during the initial ten years. Greece and other southern European economies were lured by these favourable circumstances and drove up borrowing by consumers and governments. In Spain and Ireland, easy money helped turn real-estate booms there into bubbles. After the bubble burst, the Irish government made the banks' problems its own by guaranteeing all their liabilities.

In the first quarter of this year, the debt ratios of the 17 euro zone countries as a whole rose to 87.4% of GDP. Fear of defaults crept in. The borrowing costs went up. Yield of government bond in Germany was 1.8%, while in Greece, it was close to 18%.

Bailing out Greece

Bailout measures and austerity conditions were prescribed. In fact the measures put in place were more for saving euro than saving Greece. The austerity measures for Greece and likely adoption for the same for others (Portugal, Italy and Spain) were sending jitters.

The powerhouse Germany which has built up a big export surplus with other Eurozone nations did not go out to help the suffering members. The deficit countries have no tools to fall back upon as they have surrendered their monetary sovereignty to ECB.

Long term measures were talked about: new Stability pact with the same ratios: 3% of GDP as deficit limit and 60% of GDP as debt ratio, forgetting way back in 2004 it was Germany and France who violated the conditions.

The economists wanted ECB to act and prop up the market by the same measures as adopted by the US Fed. Half hearted measures including Security Market Purchase were undertaken. But there was a limit on purchase. The markets were not impressed. Rates were shooting up.

Mere talks of long term measures including banking union and fiscal union did not calm the markets.

On Thursday, September 6, ECB President Mario Draghi acted. He announced ECB would buy government bonds with maturities of one year to three years and there will be no limit. The only pre-requirement is that countries needing assistance have to apply for it. The conditionalities, including structural reforms, would be imposed on them, which will be monitored in conjunction with IMF.

Immediately, the effect was electrifying. The euro rose 0.3% to \$1.2673 in early trading on Friday, September 7, the Spanish 10-year bond yields fell to 5.77%, below 6% for the first time since May, while yields on the equivalent Italian bonds fell to 5.19%. The euro has strengthened to a two-month high against the US dollar, as the ECB's bond-buying plans continued to please the markets.

Unhappy hardliners

Germany's Bundesbank remains opposed to the ECB's bond-buying plan. In a statement, Bundesbank president Jens Weidmann said the bond programme was, "tantamount to financing governments by printing banknotes". In fact, rumours have it that he put in his resignation paper much earlier.

In the meanwhile, there is a legal case pending before a German court. The judgment is due on September 12 on the constitutionality aspects of various programmes for providing assistance to the defaulting Eurozone member countries, by buying the government bonds. That will be a deciding factor whether ECB can proceed.

A much delayed action.

ECB wants to act as the US Fed, but remember the US Fed is for one nation. ECB is for 17 nations!

Professor Jayaraman teaches economics at Fiji National University. His e-mail address is tkjayaraman@yahoo.com